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EXCISE

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I. PRC/GULF: PRIDE AND PASSIVITY (2/12, 1991)

China's response to the Gulf war remains largely passive, but conservative elders may be arguing that more active involvement is necessary to forestall US domination of the Middle East.

Signs and portents

One high-ranking PRC official recently indicated China is considering a "more active" role in the Gulf but would prefer, for now, that other countries take the lead. A recent People's Daily article chided the EC for "becoming a political dwarf once again" as a result of its "failure to speak with one voice"--presumably against use of force against Iraq. So far, the PRC has avoided endorsing any cease-fire initiative; it expressed "appreciation" for the proposals of Yemen, Algeria, and others but said "the time is not yet ripe" to exert its own diplomatic efforts.

Yesterday Vice Foreign Minister Yang Fuchang departed for Iran, Syria, Turkey, and Yugoslavia on a visit, postponed from mid-January, that is probably intended to sample opinion, not to present PRC initiatives.

Leadership disagrees on tactics

Deng Xiaoping favors a low-key response to the Gulf crisis and international affairs in general. China's policy has been to avoid taking sides on the war and keep some distance from the United States, to the extent of seeming to equate US and Iraqi actions. Supporters of this policy do not want to put bilateral economic ties at risk over differences on the Gulf.

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China's influence in the Middle East is limited; if Beijing attempts to exert influence, it probably would do it through the UN Security Council.

When to step in

Non-authoritative articles in the PRC and PRC-controlled Hong Kong press predict a protracted ground conflict. Some Chinese worry this would include an Iraqi chemical attack and US retaliation with tactical nuclear weapons. One military official said the United States lacks the "national will" to endure a costly ground war despite its military superiority.

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Public be damned--or at least quiet

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Students and others have been warned not to demonstrate or otherwise display pro-coalition sentiments. China is also afraid its restive Muslim minorities might try to whip up support for Iraq to further their own grievances. Barring serious unrest, however, Beijing will give little weight to popular feeling in determining policy.

(DKingsland) (SECRET/NOFORN/NOCONTRACT/ORCON/EXDIS)

II. PRC/HONG KONG: DECIDING WHO'S IN CHARGE (2/13/91)

The Hong Kong governor's late-January discussions with Premier Li Peng and other officials eased tensions in PRC-Hong Kong relations. It appears the governor signaled a willingness to accommodate some PRC concerns and China agreed to be less confrontational in public as long as the British-run Hong Kong government (HKG) is willing to compromise.

The governor's visit raised the level of discussion, improved the atmosphere, and may have facilitated agreement on difficult issues. [REDACTED] 01

Proof of better relations may come in the course of upcoming joint liaison group and experts' talks, a planned March visit to Hong Kong by the head of the PRC's Hong Kong and Macao affairs office, and a projected April visit to Beijing by Foreign Secretary Hurd.

Pushing . . .

In the wake of Tiananmen, and as 1997 looms closer, Britain and the HKG have taken several steps to bolster local confidence and maximize Hong Kong's future autonomy with respect to China. These include proposing a bill of rights, planning an independent court of appeals, granting a UK right of abode to 50,000 families, and launching major projects such as a new airport. Britain has insisted it alone is responsible for pre-1997 Hong Kong administration. While acknowledging that the 1984 joint declaration prescribes consultations during the transition, Britain has hitherto interpreted this to mean after-decision briefings.

. . . and shoving

The Chinese have countered British-HKG proposals with demands that create precedents for a stronger Chinese say in Hong Kong. The PRC interprets consultations as discussions that reach consensus through compromise and, when sufficiently angered, has insisted that projects or agreements extending beyond 1997 have Chinese approval. Two issues of particular concern to Beijing are Hong Kong's post-1997 financial health, and British tolerance of "anti-PRC activities" such as demonstrations protesting China's quashing of the democracy movement.

To guarantee greater central control over Hong Kong policy, the PRC has reined in its representatives in Hong Kong, including the New China News Agency (NCNA). [REDACTED] 131

[REDACTED] A senior PRC official recently said that only China could speak for the people of Hong Kong before 1997.

The road ahead

Britain and China seem to be playing a heated, high-stakes game that has done little to alleviate loss of confidence in Hong Kong--most recently, the quasi-central Hong Kong and

Shanghai Bank moved its corporate headquarters offshore. If criticisms continue to be traded in the press, confidence is unlikely to grow.

The HKG could become more skillful in negotiations, China could return to a more moderate course before 1997, and the relaxation of Tiananmen-related sanctions against China may make it easier for the British and Chinese to resolve outstanding issues. But some British-HKG and Chinese interests differ fundamentally, and resolving the differences will be difficult. (MFinegan) (SECRET/NOFORN/NOCONTRACT/ORCON/EXDIS)

III. CHINA'S FORECAST: CLOUDY, WITH SUMMER STORM POSSIBLE
(2/10/91)

Over the next several months, Beijing is likely to face a protracted series of challenges, including a moderate resumption of inflation, difficult personnel choices, and complex foreign policy decisions. The relatively weak Chinese leadership probably will continue to avoid tough choices while it tries to portray an image of unity and stability.

Should the worst case occur--a sudden surge of inflation, heightened leadership infighting over succession-related personnel and policy issues, renewed pressure from the US and the prospect of losing MFN or having unacceptable conditions attached to its renewal, the death of one or more key leaders--China could face a summer of crisis.

[REDACTED] The Cultural Revolution, Democracy Wall, and Tiananmen all point to the dramatic rise of popular willingness to challenge the limits of a demonstrably divided central leadership.

China's leaders now are united in their commitment to keep politics within the party's inner councils, but their best efforts may not be good enough if China is faced with a confluence of contentious issues in a short time frame.

Borrowed Time?

China's retreat from the brink since June 1989 has been remarkable.

[REDACTED] The leadership's most important successes include:

--Reduced inflation. In 1990 the index of retail prices rose by only 2 percent compared with double-digit rates in 1988 and 1989, according to official Chinese data. Consumer

inflation was central to the public alienation that fueled Tiananmen; credit for the drop belongs to the hardliners' austerity program, price controls, and maintenance of income subsidies.

--Restored "stability." Heavyhanded repression following the 1989 riots has gradually given way to more subtle measures, including heavy doses of political indoctrination, official pressure to conform or feign compliance, and a vigorous crackdown on crime that has resulted in hundreds of executions. Few outbreaks of unrest have taken place since 1989; those that have were dealt with severely.

--A facade of leadership unity. Since the ouster of party chief Zhao Ziyang and his closest supporters immediately after Tiananmen, Beijing has deferred contentious leadership changes. The leadership has taken pains to hide its disagreements and to project an appearance of unity.

--Improved international relations. Beijing's temporizing has been rewarded by the slow erosion of Western-imposed sanctions. Chinese leaders seem confident that remaining restrictions will be removed over time without the need for major concessions. Simultaneously, Beijing has taken advantage of opportunities such as the Gulf crisis to build its role as a world player and restore its relations with key powers, including the US.

Yet, Beijing may be living on borrowed time. Reducing inflation has increased unemployment and sharply slowed economic growth; government efforts to put industry on a moderate, stable growth path included a large increase in credit which now threatens the possibility of another bout of inflation. The ill health of several key leaders and the need to bolster the post-Deng leadership team may soon force Beijing to make controversial personnel changes. Slow but steady improvement in US-China relations may be severely tested this spring as Congress takes up the issue of renewing MFN trading status for China. The end or winding down of the Gulf war could make China's cooperation less important to the US.

Economic Dark Clouds

Stagnation... Serious side effects have accompanied China's rather dramatic success in reducing consumer inflation. Strict credit and other controls imposed in late 1988 began to take hold in mid-1989. Decreased demand, particularly for investment goods, caused industrial growth to slow. During the six-month period ending March 31, 1990, industrial production increased by less than 0.5 percent compared with the same period in 1988-89. Industry began to recover in the second quarter, but signs of improvement were mainly superficial, and increases in output went almost entirely into inventory. Retail sales continued to decline, dropping by more than 3 percent in the first quarter of 1990.

...leads to eased credit... Shocked by stagnation, local authorities and enterprise managers put strong pressure on Beijing to ease open the credit spigot, especially for working capital. Some hardliners [REDACTED] argued for staying the austerity course. Premier Li Peng, however, succumbed to the same intense political pressure that Zhao had faced; he authorized massive injections of new credit in an effort to jump-start the faltering economy. In the five quarters ending December 31, 1990, as much as 400 billion yuan--almost one-fourth of China's GNP--was pumped into the economy. Overall, the growth of new credit in 1990 exceeded that of 1988, when rapid consumer inflation led to panic buying, the political weakening of party chief Zhao, and the ascendancy of the hardliners. 151

Initially, much of the increase in credit went toward paying back taxes and clearing outstanding debts and was not reflected in increased production. Enterprises continued to appeal for more credit to meet their normal purchasing peak in the second half of the year. Pressure to increase credit allocations during the second half was intensified by bumper summer and fall harvests and the government's pledge to avoid issuing IOUs to farmers in lieu of cash payment for their crops.

Hoped-for increases in industrial growth did not become evident until late 1990; industrial production jumped 12.7 percent in October and 15 percent in November. Retail sales, however, continued sluggish, rising only 1.1 percent in the first 11 months of the year (after adjusting for inflation), indicating that production for inventory remained a serious problem.

...and inflationary pressure. The excessive expansion of credit has sparked fears of another round of inflation, beginning as early as midyear. Consumer goods prices in 35 major Chinese cities increased 3.6 percent in October and 5.3 percent in November compared with the same months in 1989, according to official Chinese data. The cost of living during January-November rose 3.4 percent.

The Chinese method of calculating inflation indexes, however, historically has failed to give timely warning. Among the factors raising the possibility that China is headed into another bout with inflation are:

--Relaxation of price controls. Controls were maintained on many consumer prices through most of 1990; the increases occurred mainly toward the end of the year. Now, the government has announced its intention to move ahead with long-delayed price adjustments--including substantially increased prices for petroleum, steel, and coal--and to reduce consumer subsidies.

--Credit lag. Chinese economists calculate that it takes at least three months for increased credit to show up as increased production; six months for it to become manifest as an increase

in the money supply; and even longer to result in higher prices. As a result, some Chinese analysts calculate last year's massive infusion of credit is not yet fully reflected in retail prices.

--Producer/consumer price lag. Similarly, Chinese economists expect that increases in producer prices will take at least several months to show up in retail prices. Producer prices are now growing at twice the rate of consumer prices, [REDACTED] This inflationary pressure will be compounded later in the year by the impact of producer price increases already announced or planned by Beijing. b1

--Savings slowdown. Growth in personal savings in 1990 helped fund credit expansion without spiking inflation. But the rate of growth is decelerating, and the central bank probably will be forced to print money this year in order to expand credit. A sudden loss of consumer confidence could result in a drawdown of savings and a surge of panic buying.

Stormy Weather in US-China Relations

The major items on the bilateral agenda--human rights, trade, and arms sales--are issues placed there by the US. Attempts by Beijing to craft responses are likely to cause considerable dispute within the leadership.

Shifting ground. Several areas which once were cornerstones of US-China cooperation--the strategic triangle, China's pursuit of economic reforms, and such regional issues as Cambodia--have changed in ways that have sharpened differences between Beijing and Washington. Warmer US-Soviet ties, for example, have severely weakened if not eliminated China's role as a pivotal player on East-West issues.

The shift away from geostrategic cooperation as a basis for US-China ties has affected thinking in Beijing about the fundamentals of the relationship. Conservatives in the leadership claim that the US is attempting to subvert socialism through "peaceful evolution"; they voice related suspicions about US "hegemonic" ambitions--in the Gulf and more generally. The result has been a chilling effect on relations, despite private assurances that these arguments are primarily for domestic consumption.

Divergent perspectives: Human rights... [REDACTED] b1

From Beijing's perspective, China has done a great deal to address US human rights concerns by lifting martial law, allowing Fang Lizhi to leave Beijing, and being more lenient in

sentencing convicted dissidents. Deciding on responses to US pressure on human rights continues to arouse controversy, with several elders arguing that China should resist US demands. As on other issues, Deng appears to hold the balance. This year, with trials for Tiananmen protesters expected to end by mid-February, Beijing may be less able to find easy concessions. Moreover, Deng and others in the leadership are more confident about China's international standing and therefore may be less inclined to make concessions to preserve MFN.

...trade troubles... Another contentious issue likely to be raised in the MFN context is China's trade surplus with the US. For 1990 the US trade deficit is expected to be about \$11 billion, almost double 1989's \$6.2 billion. The 1991 deficit could reach as high as \$15 billion, second only to the US deficit with Japan. The size and rapid growth of the deficit undermine Beijing's arguments that trade ties--particularly MFN--are of equal benefit to both sides.

Chinese officials argue that Tiananmen-related sanctions have caused the US trade deficit with China. They claim that if the US lifted technology transfer restrictions and granted soft loans, China would buy more from the US. In fact, much of the deficit is the result of China's policy of strictly controlling imports and aggressively pricing exports in order to fuel economic growth.

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Rough Seas for the Leadership

Immediately after the 1989 replacement of Zhao with Jiang as the "core" of the new leadership, party elders Deng and Chen Yun called for at least a two-year moratorium on leadership squabbling. Although jockeying for position in the succession has continued, sometimes intensely, evidence does not suggest an irreparable breach in or polarization of the leadership at this point.

Domestic economic problems and the prospect of losing MFN, or suffering unacceptable linkage of its renewal to changes in internal policies, could widen differences among top leaders. Debate would sharpen over economic strategy and foreign policy, which rely on heavy involvement in the international economy and close ties to the US and its market.

A personnel plenum? No replacements have been named for three former Politburo members: Hu Yaobang, who died in 1989; and Zhao and Hu Qili, removed after Tiananmen. Today's Politburo is both one of the smallest in recent history and the most top heavy. Six of the 14 members hold concurrent positions on the Standing Committee. Since Zhao's removal, the party has held three full Central Committee sessions. Two dealt with economic affairs and one with measures to improve the party's public image. It seems increasingly likely that the next plenum--which could come as early as March--will deal with long-deferred personnel issues.

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Others are due for promotion:

--State Planning Commission Chairman Zou Jiahua has taken up much of the slack for Yao Yilin in conducting the State Council's day-to-day business. He is a good bet for promotion to Vice Premier, which usually carries with it membership on the Politburo.

--Foreign Minister Qian Qichen has been widely rumored to be in line for promotion to Vice Premier and Politburo member as a reward for engineering China's return to international respectability.

--Politburo alternate Ding Guangen recently has assumed broad responsibilities for relations with non-Communists and intellectuals as well as for China's relations with Taiwan, Hong Kong, and the overseas Chinese community. He could be in line for promotion to full Politburo membership.

--Regional officials associated with reform and moderation may garner higher representation on the Politburo, possibly including Guangdong Governor Ye Xuanping and Shanghai party chief Zhu Rongji.

--Wang Zhaoguo recently returned to a key party job in Beijing following several years as a provincial official. He probably is in line for promotion to the party's Secretariat, if not the Politburo.

--Hardliners have been pushing for promotion of younger ideologues, including State Council spokesman Yuan Mu and Propaganda Department Director Wang Renzhi.

A contentious process. High-level personnel changes in China are contentious in the best of times. Given the likelihood that the succession will take place soon, and the unresolved Tiananmen tensions in the leadership, the stakes are higher than usual. Leaders will be trying to bolster their positions by elevating their proteges and blocking promotions for their rivals' supporters. Heavy tradeoffs and sometimes unpredictable shifts in alliances are likely.

Since June 1989, Deng apparently has blocked almost all high-level changes out of concern not to signal instability to the restive public and fear that he might lose more than he would gain by a reshuffling of the leadership. Now, politically somewhat recovered from his Tiananmen setback, he may feel the time has come to push through some leadership changes. But he still is politically weaker and more beholden to other elders than before Tiananmen, and any deal he is able to put together

is likely to be the result of heavy compromises with more conservative elders. The result may be that no leader will gain enough political support within the Politburo to win a post-Deng showdown with opponents.

The Mortality Wild Card

Deng, Chen Yun, and several other octogenarians have been in indifferent health since Tiananmen. Deng, although [REDACTED] intervening more actively in political decisions in recent weeks, apparently has suffered several bouts of serious illness, [REDACTED] Chen [REDACTED] is extremely frail and confined to a wheelchair. Either could pass from the scene suddenly, with dramatic implications for infighting and the balance of power in Beijing.

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Equally important--and perhaps even more destabilizing--would be the sudden death or incapacitation of such key successors as Yang Shangkun (83), Jiang Zemin (63), or Li Peng (62). None of the three is believed to suffer life-threatening health problems--indeed, Yang is remarkably hearty for a man of his age. [REDACTED]

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(CClarke and DKingsland) (SECRET/NOFORN/NOCONTRACT/ORCON)

IV. FLAGSHIP GOES DOWN WITH THE CAPTAIN

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[REDACTED]

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V. YANG FUCHANG--BEIJING'S POINT-MAN ON THE GULF

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VI. FU RUI--GUANGDONG'S NEW ORGANIZATION DEPARTMENT CHIEF

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